Ontario's Proposals for the Canadian Securities Industry

Observation No. 29
C.D. Howe Institute

Thomas J. Courchene
with
John D. Todd
and
Lawrence P. Schwartz

87-00231/

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C.D. Howe Institute publications are available from:

Prentice-Hall Canada Inc.
1870 Birchmount Road
Scarborough, Ontario
M1P 2J7

Canadian Cataloguing in Publication Data

Courchene, Thomas J., 1940-
Ontario's proposals for the Canadian securities industry

(Observation, ISSN 0826-9947 ; no. 29)
Includes bibliographical references.
ISBN 0-88806-137-4

1. Brokers — Canada. 2. Stock-exchange — Canada.
I. Todd, John D. II. Schwartz, Lawrence P., 1948– . III. C.D. Howe Institute. IV. Title.
V. Series: Observation (C.D. Howe Institute).
English ; no. 29.

HG5152.C68 1986 336.6'0971 C86-094886-2

Quotation with appropriate credit is permissible.
C.D. Howe Institute, Toronto, Montreal, and Calgary.
Printed in Canada — October 1986.

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Foreword

Irreversible trends toward global capital markets and the appearance of new financial instruments and new players are part of a process that is forcing the reshaping of national legal and regulatory frameworks within which the securities industry operates. Indeed, the pace of developments in Canada has proceeded at such a rate during the past three years that it has often seemed as though policy decisions have been reached before it was possible to summarize the issues and options for public debate.

In this volume, Thomas J. Courchene (the Institute's Senior Fellow and Professor of Economics at the University of Western Ontario and at École nationale d'administration publique), John D. Todd (Econalysis Consulting Services, Ltd.), and Lawrence P. Schwartz (policy advisor, Chairman's Office, Ontario Securities Commission) have been able to summarize the thrust of the major reviews that government and the Ontario Securities Commission have undertaken, to communicate a number of the basic issues in a timely and readable way, and to relate Ontario's reform proposals to those issues.

The Institute is publishing this study with the primary purpose of promoting as full and wide-ranging a policy discussion as possible. We recognize that there will be some disagreement with the authors' specific proposals and ideas. But we also believe the authors have succeeded in capturing key issues in the often-heated debate about the appropriate regulatory environment for the Ontario securities industry. It is our hope that their analysis and perspectives will help Canadians who are interested in economic policy issues, but who are not industry experts, to obtain a better grasp of the complex debate and of the key questions for Ontario and the rest of Canada that are inherent in the debate. As the authors point out, the fundamental issue is to ensure that an efficient industry serves Canadian investors' interests well.

Courchene, Todd, and Schwartz base part of their analysis on interviews with over a score of financial industry representatives in March and April 1986. The manuscript was received by the C.D. Howe Institute in August 1986. The authors' analysis is their own and does not necessarily reflect the views of their employers.

In a similar vein, the views expressed here, while they have been subjected to peer review for accuracy and thoroughness, are published as part of the Institute's policy analysis program; they do not necessarily reflect the views of the Institute's staff, advisors, board, or members.

Wendy Dobson
President

Introduction

> *The maintenance of a vital and growing capital market in Ontario will be given a high priority. Regulations concerning the securities industry will be introduced to ensure Ontario's ability to compete in a changing, internationally-competitive market.*[1]

The Government of Ontario included this statement of intent toward the Canadian securities industry in its April 22, 1986, Throne Speech. Underlying the statement were pressures for reform that had been building for the better part of a decade. Recent merger activity — including the abortive attempt by Gordon Capital Corporation and Wood Gundy — the decision of several securities firms to go public, and the highly publicized transfer of personnel among firms have reflected not only the changing character of the Canadian securities market but also anticipated changes in Ontario's policy. It became evident, however, that any proposed Ontario legislation would have to come to grips with the rapid evolution of international capital markets and the ongoing process of financial deregulation in Canada. Through hearings, reports, and position papers, all interested parties have had ample time and opportunity in recent years to air their points of view.

On June 11, 1986, Ontario announced its long-awaited policy.[2] The securities industry is to be opened substantially to competition, both domestic and foreign, as a result of a series of changes:

- Nonresidents will be able to own up to 30 percent of a Canadian securities firm;
- Foreign securities firms will be able to apply to become foreign dealer registrants, able to operate freely domestically but subject individually and in the aggregate to capital limitations;
- Canadian financial institutions will be able to own 30 percent of a Canadian securities firm;
- Similarly, Canadian nonfinancial firms will be able to own 30 percent of a Canadian securities firm.

The Minister of Financial Institutions, Monte Kwinter, concluded the announcement of these changes by noting that "the principles...are designed to ensure that our financial markets are so structured that Toronto will be

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[1] Ontario, *Speech from the Throne*, April 22, 1986, p. 9.

[2] Ontario, Ministry of Financial Institutions, "Kwinter Favours Change in Securities Industry," *News Release*, Toronto, June 11, 1986.

able to maintain its rightful place not only as the centre of Canada's capital markets, but as a major international financial centre."[3]

The purpose of this study is to present the background, challenges, and options available prior to Ontario's decision, and to evaluate the announced policy.

Since securities industry policy falls within provincial jurisdiction and since Ontario has, up to the present at least, largely called the tune, the focus on Ontario is not as "provincial" as it might appear.

The first section of the study focuses on the status quo in the Canadian securities industry, and emphasizes both the regulatory structure and some key characteristics of the Canadian securities market. The second section focuses on the various federal and provincial proposals for reform of the securities sector. Together, these two sections provide the backdrop for the ensuing analysis.

The next two sections focus, respectively, on the likely underlying objectives of Ontario's policy and on the challenges facing the policy authorities. The study then presents a comparison of the two formal reform proposals: recommendations made by the Ontario Securities Commission in 1985 and those by the Ontario Task Force on Financial Institutions in 1985. This is followed by our own recommendations for reform. In the last section, we evaluate Ontario's proposals for the securities industry and present a short conclusion.

The Status Quo[4]

The Registered Market

Approximately 100 securities firms are registered with the Ontario Securities Commission (OSC). These firms are also members of the Investment Dealers Association of Canada (IDA) or members of Canadian stock exchanges.

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[3] Ibid., p. 5.

[4] Much of this study draws on earlier research, including a round of interviews with industry people, conducted for the Ontario Securities Commission (see Thomas J. Courchene with John D. Todd, *Alternative Futures for the Canadian Securities Industry: An Economic Impact Analysis* [Toronto: Ontario Securities Commission, March 1986]). It also draws on Thomas J. Courchene, "A Real Secure Industry or a Real Securities Industry" (Submission to the Ontario Securities Commission in respect of its Securities Industry Review, London, Ontario, Centre for the Analysis of National Economic Policy [CANEP], Department of Economics, University of Western Ontario, CANEP Working Paper 84-01, 1984); and idem, "Regulating the Canadian Financial System:

They are subject to two general sorts of regulations: registration requirements and ownership restrictions.

Registration Requirements

Without resorting to detail, the Ontario *Securities Act* contains the following general registration provisions:

- those who trade in securities must register as dealers;
- those whose trading involves the retail distribution of securities as principal or agent must register as underwriters; and
- those who advise on securities investments must register as advisers.

In addition to some bonding and capital requirements, registration typically involves adherence to certain "professional" requirements, such as education standards and know-your-client, suitability-for-investment, and disclosure rules.

Ownership Restrictions

Ownership or capital restrictions exist both on domestic and on foreign investors in the regulated securities market. On the domestic side, no single nonindustry investor can hold more than 10 percent of the voting shares of a securities firm. On the foreign side, nonresidents in the aggregate cannot hold more than 25 percent of any class of securities and no single nonresident investor can own or control more than 10 percent of any class of securities. This is frequently referred to as the "25-10 provision".

While the option of going public has long been available, it has only been since mid-1986 that a significant number of securities firms have begun to take advantage of this option.

The Nonregulated or Exempt Market

One rationale for regulating the securities industry is to protect the investing public from such things as fraud, inadequate disclosure, and conflict of interest. The regulatory authorities have long recognized, however, that there are certain classes of securities and agents for which such concerns are

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Paradigms, Principles and Politics," in Jacob Ziegel, Leonard Waverman, and David Conklin, eds., *Canadian Financial Institutions: Changing the Regulatory Environment* (Toronto: Ontario Economic Council, 1985), pp. 3–78. Research for the study was supported by CANEP.

not likely to be very important. These classes have come to be referred to as "exemptions" under the act or as "unregulated" aspects of the securities market.

In general, there are two types of exemptions. One applies to certain classes of securities where the very nature and quality of the instruments (government bonds, for example) is such that there is really no need for registration requirements in order to protect the investing public. The other type of exemption relates to the nature of the participants themselves. The argument here is that registration on grounds of protection and full disclosure is not needed for trades that involve sophisticated and knowledgeable investors who are quite capable of independent analysis of the merits of any investment.

Exempt Trades

The *Securities Act* provides that in some 23 specified trades, no registration is necessary. There is, for example, an exemption for trades involving certain financial institutions and governments. The rationale for granting such an exemption is that these financial institutions are regulated by their own governing statutes and that financial institutions and governments are presumed to have the expertise and sophistication to determine for themselves the merits of their investments.

The act also provides an exemption from registration for trades to companies and persons recognized by the OSC as exempt purchasers. Exempt-purchaser status is intended primarily for institutions with substantial pools of capital and sophisticated investment advisers, such as financial institutions licensed to do business in Ontario as well as professionally managed pension and mutual funds.

By far the most controversial of the exempt trades are those referred to as "private placements". The act provides an exemption from registration for buyers who purchase as principal and for securities that have an aggregate acquisition cost of not less than $97,000. The rationale for this exemption is the presumed sophistication of an investor with this amount of money available for investment.

Exempt Securities

The second category of exemption relates to certain classes of securities. Registration is not required for trading in bonds and debentures (direct or guaranteed) by the various levels of government in Canada or foreign countries, by various financial institutions, or by development banks. Short-term

Table 1
Bond and Money Market Trading Report, 1985

Money market trading[a]	$ millions
Canada Treasury Bills	392,066
Provincial bills	28,198
Municipal bills	576
Canadian bankers' acceptances	107,623
Canadian bank paper	53,210
Corporate paper	99,031
Trust & mortgage company paper	13,596
Other	24,332
Total money market trading	*718,632*
Bond trading[b]	**$ millions**
Canada bonds due within 3 years	25,155
Canada bonds due in 3–10 years	64,377
Canada bonds due in more than 10 years	80,514
Provincial bonds due within 10 years	13,992
Provincial bonds due in more than 10 years	12,186
Municipal bonds	1,389
Canadian bank paper	2,453
Trust & mortgage company paper	1,715
Other corporate paper	511
Corporate bonds due within 10 years	5,515
Corporate bonds due in more than 10 years	3,794
Strip bonds (residuals)	3,028
Other	7,707
Total bond trading	*222,336*
Total money market and bond trading	*940,968*

[a] Due within one year.
[b] Greater than one year.

Sources: *Securities Industry Statistics*, December 1985; Investment Dealers Association of Canada, *Bulletin* no. 1400, March 3, 1986.

negotiable promissory notes or commercial paper in denominations greater than $50,000 are also exempt. Once again, the rationale for these exemptions is one or more of the following: that the issuers are regulated in their own right; that the nature of the instruments is such that there is no need for the protection registration affords; or that the purchasers (for commercial paper, for example) are thought to be sufficiently sophisticated and knowledgeable to evaluate the investment.

Finally, most international securities trading is also unregulated. Nonresident firms may deal in Canada in exempt securities and they may also deal with exempt institutions in any other securities. Domestic and foreign financial institutions may also underwrite any securities issues designed to be placed in international markets.

Thus, a considerable portion of the domestic market in securities is effectively unregulated, which, in turn, implies that firms need not be registered or subject to ownership requirements in order to engage in trading. Table 1 presents a breakdown of the nearly $1 trillion traded in the bond and money market in 1985. Most of this trading falls into the designation of the exempt market. Excluded from the table is $60 billion in stock exchange trading, which is restricted to registered dealers.

The Provincial Interface

In the past, Ontario's securities industry regulations have become, in effect, the national standard. Recently, however, Quebec has opened up its securities industry as part of a more general deregulation of the financial sector in that province. Of particular importance is that Quebec no longer has any ownership requirements, although the Commission des valeurs mobilières du Québec (Quebec Securities Commission) must approve any ownership changes.

Thus far, no financial intermediary, domestic or foreign, has acquired more than 10 percent of a Quebec securities firm. Part of the reason for this is that an outsider who owns more than 10 percent of a domestic securities firm is denied direct access to the Toronto Stock Exchange (TSE). What this implies is that the likely route for acquiring, say, a wholly owned securities firm will be to start up a new one, since established firms will be loath to give up their TSE access. For such new firms, the inability to gain access to the TSE may not be as restrictive as it might at first appear, for several reasons. First, there is an increasing tendency for interlistings among Canadian and U.S. exchanges. Second, there has been a rather dramatic recent increase in Quebec-based activity reflecting the success of the Régime d'épargnes-actions (Quebec Stock Savings Plan). Third, there has been an even more recent move toward privatizating many of Quebec's crown corporations. Fourth, such securities firms would have the advantage of a Canadian base from which to conduct international placements, an activity for which the parent may have substantial expertise. Most importantly, however, with the rapid evolution in the structure of the securities industry, it may only

be a matter of months before such firms will be allowed TSE access in any event.

While most of the other provinces have no ownership requirements, Ontario's rules have tended to apply across the board, since firms registered in other provinces desire access to the TSE. British Columbia recently established a securities commission, however, and is soon to release ownership requirements. Our best "guess" is that these requirements are likely to be more liberal than those now contemplated by Ontario, largely because of British Columbia's desire to capitalize on Finance Minister Wilson's designation of Vancouver as an international banking center in the 1986 federal budget.

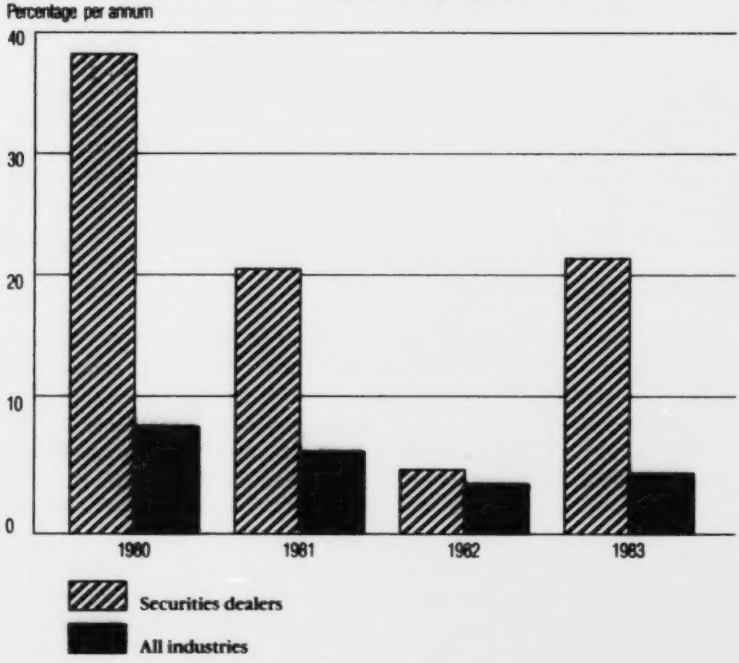
Industry Capital and Profits

At the end of 1985, the entire capital base of the 100 or so Canadian securities firms was roughly $1 billion. To put this in some perspective, several U.S. securities firms have a capital base exceeding that of the entire Canadian industry. Merrill Lynch alone has a capital base of close to U.S.$4 billion. To be sure, Merrill Lynch probably is not the relevant benchmark when it comes to the future of the Canadian firms. Nonetheless, the comparison does serve to emphasize two important points. First, unlike banks, trust companies, and other sectors of the financial system, Canadian securities firms, individually and in aggregate, are very small relative to those elsewhere. Second, financial markets are becoming increasingly globalized, and the premium on access to capital is increasing correspondingly for firms wishing to become meaningful players on the international scene. Not surprisingly, therefore, the issue of ownership requirements as they relate to capital access is one of the underlying pressures for regulatory reform.

The Canadian industry does exceedingly well, however, when it comes to return on equity. Figure 1 compares securities firms with all industries on the pretax return on capital employed. Recent buoyant markets mean that securities firms presumably have done even better over the more recent past.

In spite of the fact that, over time, the regulated portion of the overall Canadian securities industry has been shrinking, the protection afforded by the regulated market obviously has been of substantial value to the industry. This shrinking share is offset by the fact that the overall amount of Canadian securities business has been growing rapidly, as might be expected when the recent levels of federal and provincial deficits are taken into account. The fear that foreign securities firms and domestic financial intermediaries

Figure 1
Pretax Return on Capital Employed, 1980 – 83



Source: Statistics Canada, *Corporation Financial Statistics*, Cat. no. 61-207, various issues.

are poised to increase substantially their activity in the exempt markets, however, is also one of the factors underlying the whole reform process.

Eurotrading Activity

Table 2 presents recent data on the offshore, new-issue securities business. The left-hand panel of the table focuses on Euro-Canadian bond issues between January and June 1985. Of the $1.508 billion raised by Canadian issuers, Canadian lead managers accounted for $812 million and foreign lead managers for $696 million. Of the $896 million raised by foreign issuers, foreign lead managers accounted for $689 million. The last column of the panel

Table 2
Eurotrading, January–June 1985

	Euro-Canadian Bond Issues (Can.$ millions)			Euro-U.S. Bond Issues (U.S.$ millions)
	Canadian	Foreign	Total	
Canadian lead-managed[a]				
Government	390	0	390	149
Corporate	422	207	629	435
Subtotal	*812*	*207*	*1,019*	*584*
Foreign lead-managed				
Government	240	0	240	526
Corporate	456	689	1,145	1,940
Subtotal	*696*	*689*	*1,385*	*2,466*
Total government	*630*	*0*	*630*	*675*
Total corporate	*878*	*896*	*1,774*	*2,375*
Total bond issues	*1,508*	*896*	*2,404*	*3,050*

[a] Proportionate credit to lead managers.

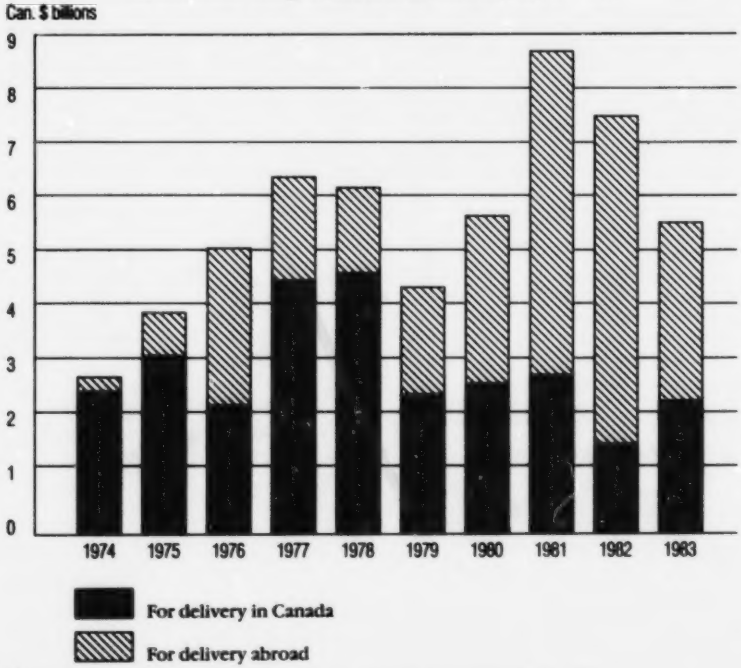
Source: Morgan Stanley Canada, *Canadian Securities in Foreign Capital Markets*, June 30, 1985.

combines the data, revealing that Canadian lead managers accounted for roughly $1 billion of the $2.4 billion total. This represents a substantial Canadian presence, but it is important to note that just two firms, Orion Royal Bank — the merchant banking subsidiary of The Royal Bank of Canada — and CIBC Ltd., accounted for $600 million of this $1 billion, while Wood Gundy accounted for a quarter of a billion and three other securities firms for amounts under $100 million.

The right-hand panel presents similar data for Eurodollar issues by Canadians. Here the dominance of foreign lead managers is more evident — 80 percent of total Eurodollar proceeds were by foreign lead managers. Again, Orion Royal Bank accounted for the bulk of the Canadian-led issues — U.S.$316 million of the U.S.$584 million total. For government issues, the foreign dealers were nearly as dominant. Clearly, Canadian governments rely much more on foreign than on domestic dealers, which in itself is a telling commentary on the success of Canadian and Ontario regulatory policies in the securities area.

The final evidence relating to the Euromarket is contained in Figure 2, which reveals the increasing reliance of Canadian corporate borrowers on offshore markets. In combination with the above data relating to the dominance of foreign firms and merchant banking subsidiaries of chartered banks,

Figure 2
Gross New Corporate Bond Issues, 1974 – 83



Source: CIBC Limited, *Presentation to Securities Industry Policy Review* (November 1984).

Figure 2 portrays rather starkly the erosion of the domestic securities industry's market share of the bond financing of Canadian corporations.

With this brief description of the status quo, we now focus on the various proposals for redesigning the regulation of the securities industry.

Proposals for Reform

The Joint Securities Industry Committee Report

In 1983, Gordon Capital Corporation (then Daly Gordon Securities) attempted to enter into a joint venture with a Belgian firm to carry on the "exempt" part of its securities business. The rationale was that if other

players in the exempt market were not constrained by ownership or access to capital, then registered firms should be able to split their activities, with one part of the firm remaining in the regulated market and the joint-venture part working the exempt market. The IDA and the TSE vetoed the proposed joint venture. In early 1984, however, the OSC called for hearings into the ownership, capital, and regulatory aspects of the Canadian securities market.

In September 1984, the Joint Securities Industry Committee (JSIC) issued its report to the OSC.[5] The report was designed to present the industry's view of the issues and to serve as a catalyst for other submissions. Essentially, the JSIC report argued:

- that the capital base of the securities industry was adequate and, therefore, that alterations in existing ownership restrictions were not warranted;
- that all firms now conducting business in the domestic exempt market should be required to register with the OSC and to comply with the ownership restrictions in force for the registered market; and
- that the international aspects of the securities business should remain exempt.

In tandem, these recommendations called for a dramatic increase in regulation — indeed, for a dramatic retrenchment of the status quo.

This was a remarkable document in many ways. From the vantage point of economic analysis, it certainly served to rivet attention not only on the perennial issue of protection versus competition but also on whether the ultimate role of regulation is to serve the interest of the public or of those being regulated. In view of the general move toward financial deregulation, however, it seems highly likely that this approach is a nonstarter.

The OSC (Dey) Report

In early 1985, the OSC released its final report — usually referred to as the Dey report, after then OSC chairman Peter Dey — on the ownership issue.[6] The report argued for a substantial easing of ownership restrictions.

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[5] Joint Securities Industry Committee, "Regulation and Ownership of Market Intermediaries in Canada" (Submission to the Ontario Securities Commission on behalf of the Alberta, Montreal, Toronto, and Vancouver Stock Exchanges and the Investment Dealers Association of Canada, Toronto, 1984).

[6] Ontario Securities Commission, *A Regulatory Framework for Entry and Ownership of the Ontario Securities Industry*, report to the Minister of Consumer and Commercial Relations (Toronto, 1985).

Instead of being limited to 10 percent, any individual or financial institution (domestic or foreign) would be able to acquire a 30 percent ownership stake in a Canadian securities firm. The report also recommended a new class of registrant: the foreign dealer registrant. Firms in this class would have the same status as Canadian firms, but each would be restricted in its capital to 1.5 percent of the industry total and, as a group, limited to 30 percent of industry capital. Except for trading in some exempt securities (for example, government bonds and commercial paper in denominations of $50,000 and up), the current exempt market would be open only to domestic and foreign registered firms. And since Ontario does not regulate offshore activities, the underwriting of Euro-issues would still be open to all.

This is more akin to reregulation than deregulation: while capital restrictions and participation by foreign securities firms would be eased, opening up the Canadian securities industry considerably, the boundaries of the exempt market also would be expanded considerably. One notable feature of the Dey report is that it would exclude offshore merchant banking arms of the schedule A chartered banks and the schedule B banks from acquiring foreign-dealer-registrant status. At this juncture, it is instructive to note that, with some modifications, the new Ontario proposals are modeled on the Dey report.

The Dupré Report

The most recent document directed toward Ontario regulatory policy in the financial sector is the *Final Report* of the Ontario Task Force on Financial Institutions (henceforth referred to as the Dupré report, after its chairman, Stefan Dupré).[7] The Dupré report was more in line with Ontario's traditional "four-pillar" philosophy — that is, the separation of function and ownership of banks, trust companies, insurance, and securities firms. It generally favored maintaining functional and ownership separation across the pillars and encouraged widely held ownership of financial institutions. Not surprisingly, it did not go as far as the Dey report in recommending that the securities sector be opened up. It did not recommend foreign dealer registrants, for example, as did the Dey report. Rather, it argued that issues relating to foreign ownership of the industry should be decided in the context of any Canadian-U.S. free trade negotiations. The Dupré report did recommend, however, that current ownership limits be eased from 10 percent to

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[7] Ontario, Task Force on Financial Institutions, *Final Report* (Toronto, 1985).

20 percent. It also effectively lent its blessing to the continued existence of the exempt markets, as currently defined.

The Federal Government's Reports

The federal government's Green Paper on financial institutions[8] essentially endorsed the process of ongoing ownership integration across the pillars, but argued that this would have to be accomplished by federally regulated financial holding companies (FHCs). The Green Paper also recommended opening the door for FHCs to acquire securities firms, if the provinces were willing.

A report by the House of Commons Standing Committee on Finance, Trade and Economic Affairs (generally referred to as the Blenkarn report, after committee chairman, Don Blenkarn) espoused an even more liberalized regulatory regime.[9] This document rejected the Green Paper's proposal for a mandatory FHC for cross-pillar integration, recommending instead that FHCs, subsidiaries, and upstream and downstream holding companies could all be utilized in expanding across the pillars. While the Blenkarn report did not devote much time or effort to the securities industry, the thrust of its argument was that, if the provinces were willing, there should be no reason why other financial intermediaries (including chartered banks) should not be able to acquire securities firms.

Finally, a recent report by the Senate Standing Committee on Banking, Trade and Commerce (referred to as the Murray report, after committee chairman, Senator Lowell Murray)[10] basically endorsed the recommendations of the Blenkarn report. It then went somewhat further by arguing that there would appear to be no reason why the securities industry should not have the range of expanded powers recommended for the rest of the system. Hence, under the Murray report's recommendations, the securities industry also would have the ability to expand across the pillars, either through subsidiaries or holding companies, again assuming that the provinces would be willing to go along.

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[8] Canada, Department of Finance, *The Regulation of Canadian Financial Institutions: Proposals for Discussion* (Ottawa: Supply and Services Canada, 1985).

[9] Canada, Parliament, House of Commons, Standing Committee on Finance, Trade and Economic Affairs, *Canadian Financial Institutions* (Ottawa, 1985).

[10] Canada, Parliament, Senate, Standing Committee on Banking, Trade and Commerce, *Towards a More Competitive Financial Environment* (Ottawa, 1986).

With these reports as backdrop, we now proceed to focus in more detail on the range of issues that confront Ontario policymakers. We begin with our view of the likely policy objectives or preferences of the Ontario government and then proceed to outline some of the ways in which the evolution of financial markets, domestically and internationally, impinges on the Ontario government's policy freedom.

The Underlying Policy Objectives

The securities industry is one of the world's most rapidly expanding industries. It is "high-tech", with its emphasis on the application of telecommunications and computer technology, and it is a substantial employer, with an emphasis on human capital. We take it for granted, therefore, that one of Ontario's overriding goals is to attract the industry to Toronto. While it is unlikely that Toronto will ever rival London, Tokyo, or New York as a key financial center, it is reasonable to assume that Ontario wishes to ensure that Toronto becomes the premier financial center after those great cities.

Ontario's second goal is to ensure that, within the Toronto market, Canadian-owned securities firms can expand, thrive, and, if they so wish, seek world-class status.

In achieving these goals, it is critical not to lose sight of the ultimate rationale for a securities industry — namely, capital formation. For Ontario's, and Canada's, manufacturing base to remain competitive in the light of worldwide industrial restructuring, it is essential that enterprises have access to capital on the best possible terms. This is the third policy objective.

While these three objectives are the primary ones in the analysis that follows, there are many other objectives that may be relevant. We shall mention only two: that Ontario maintain jurisdiction over the securities industry and that the industry remain under the control of industry insiders. As a matter of fact, we are not in agreement with this last objective and we later challenge its relevance. However, since it appears to be part of the tradition associated with the Canadian securities industry, it has been included for the time being.

Challenges to the Industry

Concerns relating to reform or deregulation of the securities industry do not arise in a vacuum. In order to assess the implications of alternative deregulation or reregulation scenarios as they relate to the underlying objec-

tives, it is imperative that one understand the nature of the challenges confronting the industry.

The Globalization of Markets

The first challenge is the rapid globalization of capital markets, initially the markets for debt, but increasingly the markets for equity. Much of this trend has to do with the application of state-of-the-art telecommunications and computer technology. But it also has to do with financial innovations, such as currency swaps, that minimize the problems associated with dealing in national currencies and thereby serve to integrate the world's various capital markets. To be a major player in this global game requires the ability to trade and distribute in the domestic issues and the money markets of Tokyo, London, and New York. A few Canadian securities dealers have a substantial foreign presence but none has the capital or the scope of operations to challenge effectively the major players, or, indeed, to assume the role that the offshore merchant banking subsidiaries of the chartered banks play internationally, as pointed out above. The argument here, to repeat, is not that Canadian securities firms should strive to become international giants on the order of a U.S. firm such as Merrill Lynch. This is neither likely nor necessary. Rather, it is that the lack of capital and scale to generate a substantial international trading facility places Canadian firms at a disadvantage and results in the increasing penetration by foreign firms into the international market activities of Canadian issuers and investors.

Foreign firms have long dominated the Eurodollar issues of Canadian governments and enterprises. But what is occurring now is an escalation of foreign activity in Canadian exempt markets. These foreign firms' global presence and financial innovations such as currency and interest-rate swaps are enabling them to begin to underbid Canadian firms in both the primary and secondary exempt domestic markets. Until recently, foreign firms appear to have been reticent to establish operations in Ontario. Perhaps they still recalled the Ontario government's response to Merrill Lynch's takeover of a Canadian securities dealer in 1969, which led to the current restrictions on foreign dealers, and they feared new measures if they were to invade the exempt markets too aggressively. Hence, most of the activities of foreign securities firms have been of the "suitcase" variety, operating out of offshore offices.

This attitude now appears to be changing. Goldman Sachs, for example, is rumored to be planning to set up shop in Toronto in late 1986. Presumably, the rationale is that if the Dey report were implemented, Goldman

Sachs would qualify as a foreign dealer registrant. If the Dupré report were implemented instead, then at least the firm would be free to focus its activities on the large domestic exempt market. In any event, with the arrival of Goldman Sachs, the status quo will be altered permanently, even in the absence of any policy measures taken by the Ontario government.

Unless Canadian firms have the flexibility to compete effectively with these foreign firms, they stand to lose this critical core of activity that effectively sustains their operations. Moreover, foreign firms, even if granted limited registrant status, probably would not attempt to expand initially into the retail market. Rather, they would focus their expertise and capital on particular niches of the exempt market. With an eroding domestic base, Canadian firms would have even greater difficulty competing with foreign firms. This is the first challenge.

The Shift from Agent to Principal

The second challenge is the rather dramatic shift that has occurred away from dealers acting as "agent" in transactions and toward their acting as "principal". The "bought deal" typifies this tendency. Issuers find the bought deal attractive, since the risk of price changes during the distribution of a security is transferred from the issuer to the intermediary. This trend should not be discouraged, since principal transactions improve economic efficiency. Well-capitalized intermediaries are able to diversify distribution risk, whereas issuers cannot. The implications of this development are clear: to act as principal rather than as agent requires substantially more capital, so that the competitive edge will go progressively to more highly capitalized foreign securities firms and merchant bankers at the expense of relatively undercapitalized domestic firms. It is largely for this reason that some schedule B banks, such as Citibank Canada, have been able to establish themselves so quickly in areas such as currency swaps and offshore underwriting. This activity surely will grow, because once borrowers experience the advantages of time, price, and certainty associated with these transactions, they will be loath to return to dealing with security firms on an agency basis.

The Integration of the Four Pillars

The third critical challenge arises from the ongoing integration of the four pillars, both in Canada and throughout the world. Within Canada, all financial institutions are encroaching on the securities pillar. Some of this intrusion is arising because legal restrictions on entry into this pillar are

being lifted. The Toronto Dominion Bank and The Royal Bank of Canada, for example, now offer discount brokerage services, while mutual companies in Quebec have gained the right under Bill 75 to diversify through downstream holding companies into various aspects of the securities pillar.

This intrusion also is occurring partly because of the inherent fungibility of money and ideas. Highly innovative products or creative institutions that impinge on securities-related functions are able to spring up because of the inherent difficulty of providing a workable distinction between financial instruments or institutions that come under the registered market and those that qualify for exempt-market status. Phrased differently, the range of permissible instruments and institutions in the exempt market is expanding, and undoubtedly will continue to do so. This is consistent with the fact that, as Figure 1 indicates, the current regulatory regime enables the protected Canadian securities industry to earn a high return on capital. As noted above, the inherent fungibility of money and knowledge will cause these high returns to be progressively squeezed by increased competition.

The most significant development in this regard is that the line of demarcation between securities and other financial instruments is becoming blurred. In particular, there is an escalating tendency for bank loans to resemble securities. This is typically referred to as "securitization" of bank loans. The tendency probably began with the development of mortgage-backed securities, but the phenomenon is becoming much more widespread. Regular loans are now being traded in some capital markets, with the result that they are becoming indistinguishable from securities. If this trend continues, commercial loan contracts increasingly will resemble prospectuses. It is only natural that the chartered banks will follow their customers' demands and progressively enter what was viewed traditionally as the securities pillar.

It is probably the financial conglomerates, however, that are making the greatest inroads into the securities pillar. For example, The Great Lakes Group and Hees International, both part of the financial holding company of Edper Investments, are becoming domestic merchant bankers. Such initiatives are effectively unregulated, since they appear to fall between the regulatory "cracks", as it were. It is important, moreover, not to underestimate the significance of these developments for the evolution of the Canadian securities industry. The combined capital base of Hees and Great Lakes exceeds that of the *entire* Canadian securities industry.

As a final comment on the integration of the four pillars, it is instructive to note that many of the schedule B banks are also in reality merchant bankers. The trading desk of Citibank Canada can rival most, if not all, of the desks of Canadian-owned securities firms. Part of this is a natural response

to the restricted capital or asset base within which the schedule B banks are expected to operate. Merchant banking — that is, securities-related activities — is the obvious way to economize on capital and is an activity that comes naturally to most schedule B banks because their parent companies are merchant bankers. It is somewhat ironic that the advent of schedule B banks is as much a challenge to the Canadian securities industry as it is to the Canadian banking industry.

The message of these developments is by now a familiar one: the era of increased competition has dawned on the Canadian securities industry. To compete successfully in the face of challenges posed by foreign and other resident financial institutions, Canadian investment dealers need greater freedom to bring in outside capital and to establish improved international linkages.

Ongoing Financial Deregulation

A fourth challenge to the Canadian securities industry is the ongoing process of financial deregulation that is reflected in federal government reports on the reform of the financial sector. Interestingly enough, the positions of both the Dupré report and the federal government's Green Paper appear to have fallen in line with the four-pillar concept, although they contained different definitions of what the four pillars imply. The Green Paper apparently defined this concept as one that ensures each core instititution has its own legislation and regulatory structure. Because the concept of financial holding companies preserves this structure, even though it permits ownership integration across the pillars, the Green Paper was able to argue that its proposed FHC structure would be consistent with the preservation of the four pillars. The Dupré report, however, viewed the separation of ownership as integral to maintaining the pillars.

Ontario must be one of the few remaining jurisdictions in the world espousing separation both by function and ownership. Most of continental Europe only has one pillar. Australia recently has deregulated fully. Japan appears to be in the process of removing many of its restrictions. In the United States, while it is true that the Glass-Steagall act prevents the linking of banks and securities firms, other financial institutions and firms can own securities firms. Prudential, for example, owns Bache, American Express has bought into Shearson Lehman Brothers, while Sears Roebuck owns Dean Witter Reynolds. In Canada, as noted above, the federal government appears to be willing to open up the financial system considerably. Already, trust and loan companies are gearing up to take advantage of their expected new

powers. The chartered banks are pressing Ottawa to undertake an early review of the *Bank Act* in order that they, too, can be granted similar powers. The "Montreal challenge", which is dealt with in the next section, is a direct result of this difference in philosophy. The direction of change is clear. Whether or not there is some "underlying" validity to the Dupré report's approach to the four pillars, in the final analysis Ontario probably will be powerless to stop this trend toward integration.

The Montreal Challenge

Many industry participants take the position that there can be only one important financial market in Canada. Since Toronto is the "obvious" location, they tend to downplay the importance of financial deregulation in other provinces, particularly Quebec. As support for this position, they point out that while it is possible to own outright a Quebec-based securities firm, there are as yet no takers. And they downplay the importance of Finance Minister Wilson's budget recommendation that the federal government move to establish Montreal and Vancouver as international banking centers (IBCs).

We recognize this position but worry that there may be dire implications for the Toronto-based industry if Ontario ignores these developments. In part, they represent one more aspect of the growing internationalization of the securities industry.

While Ottawa has not yet elaborated on the IBC concept, it may be an incentive package that includes the following items:

- tax-free treatment of an institution's earnings;
- preferential treatment for tax purposes of the income of individuals participating in these markets; and
- substantial relaxation of regulations.

Were all three items to be part of the package, the incentive to establish a presence in a designated IBC would be substantial.

The range of activities that would fall under the purview of such a center is uncertain. But Quebec is clear about what it wants this range to be. Bill 2, Quebec's enabling legislation for an IBC, was introduced in December 1985, well before Finance Minister Wilson's announcement — although its final passage, on May 29, 1986, followed the federal budget. Allowable activities included in the legislation are:

- purchase and sale of Canadian securities on behalf of nonresidents;
- purchase and sale of foreign and international securities on behalf of Canadian residents;

- underwriting of securities issued by Canadian borrowers in any currency and placed with nonresidents abroad;
- underwriting of securities issued by foreign borrowers in Canadian currency that are placed with Canadian residents; and
- clearing of eligible securities to ensure the necessary financial support within an exchange-trading framework.

While Ottawa may have given its blessing to Montreal as an international *banking* center, Quebec's legislation clearly is phrased in terms of an international *financial* center (IFC) that would include activities which currently fall under securities and/or merchant banking functions.

It is widely expected that the Quebec government will bestow specific concessions on such a center. An August 1, 1986, lead story in *Le Devoir* suggested that Quebec would exempt firms operating in the center from the 13 percent Quebec corporate tax, from the 3.25 percent assessment for health care, and from the 0.45 percent capital tax. Moreover, it is expected that employees arriving from offshore to work in the center will be exempt from Quebec personal income tax for 2 years, while those employees already domiciled in Canada will be able to exempt one-half of their incomes from that tax.

Under the existing constitutional division of powers, it is not obvious that the federal government can do much to prevent this initiative by Quebec. Indeed, Quebec's hope is that Ottawa will agree with the expanded definition of activities the legislation allows and offer a corresponding set of tax concessions. Lest one tend to rule out this possibility, it is instructive to recall that only one year ago, few Canadians would have predicted that Quebec would have been able to convince Ottawa to accept the idea of such a center in the first place.

Thus, it is clear that Quebec is targeting all securities transactions that involve either a foreign currency or a foreign buyer or seller. This represents an enormous and rapidly expanding amount of business. It has the potential for drawing in the entire international exempt market. To the extent that the IBC or IFC concept proves successful, it seems that all foreign securities firms and domestic financial institutions will be induced to establish IBC or IFC subsidiaries, and Canadian securities dealers effectively may be forced to establish a significant Montreal presence for their international dealings. Failure to do so might mean their losing out on even the international business that they now transact. Presumably, the Quebec government and its various financial regulatory agencies would ensure that institutions in these IFCs have access to the Montreal Stock Exchange. One need say no

more about the potential effects that this development could have on the vitality of Toronto as a financial center, on the vitality of the TSE, or on the prospects for Toronto-based Canadian dealers.

It is possible to overstate the impact of these developments. In truth, we do not have a very firm fix on the likely impact of IBCs or IFCs. In our round of interviews, however, one major Toronto-based dealer informed us that Montreal is very appealing even in the absence of the IBC/IFC concept because of the additional flexibility Quebec allows. The dealer further predicted that Ontario will have to make significant moves in the direction of deregulation or the firm probably would shift major parts of its operations — particularly those relating to international dealings — to Montreal.

On a somewhat related point, there appears to be virtually no support among dealers for the Dupré report's recommendation that Ontario link the issue of foreign dealer participation in the securities market with the Canadian-U.S. free trade negotiations. Dealers apparently feel that the issue is a multilateral, not a bilateral, one and that the likely time frame (2–3 years) for trade negotiations is far too long since the issue has to be addressed now. To these concerns, one could add that the federal government has now tipped its hand: it wants to build up financial centers outside Toronto. Hence, Ontario is not likely to be willing to relinquish this aspect of its jurisdiction to the federal government. Indeed, Ontario is placed in a very peculiar position. If Ontario deems the development of IBCs or IFCs as a threat to Toronto's viability, its first line of defense may be to lobby Ottawa to include Toronto as one of the designated international centers. Assuming that such efforts will not be successful, the next best approach — and perhaps it is the best approach — might be to alter the regulatory environment in Ontario in ways that would serve to minimize the attraction of an international banking or financial center.

On criteria of economic efficiency, we are not enthusiastic about locational subsidies such as those embodied in either IBCs or IFCs. Canada's track record of industrial subsidization is a rather depressing story. Yet we may now be in for more of the same. What is particularly disconcerting in the financial area is that there are alternative ways to increase efficiency without resorting to subsidization. Basically, this involves altering the domestic environment in ways that reflect developments in other parts of the world and in response to the increasing internationalization of the markets for credit and capital. Indeed, it may well be the case that this recent federal government initiative reflects Ottawa's frustration that the provinces, particularly Ontario, have been dragging their feet in coming to grips with the new reality in world securities markets. In any event, we believe that

Montreal's challenge to Ontario's existing domination of the Canadian securities industry is serious, particularly if Ottawa comes four-square behind Quebec's version of IFCs.

Reciprocity

Reciprocal treatment represents a further challenge to the current regulatory environment. If Canadian firms desire access to foreign exchanges, this access may be available only on a reciprocal basis. The United Kingdom's financial services bill, for example, contains such a reciprocity provision, and the Japanese also are likely to insist on reciprocal treatment. To the extent that reciprocity is an issue, a policy that permits foreign dealer registration may be essential to ensure full access by Canadian securities dealers and banking operations to foreign financial markets.

Summary

So far, we have focused on three principle objectives of Ontario's policy toward the Canadian securities industry: to domicile the industry in Toronto, to enhance the role of Canadian firms in the securities market, and to provide efficient services to the industry's users. We have identified six challenges that must be taken into consideration if these objectives are to be achieved: the increasing internationalization of capital markets; the movement toward activities where dealers act as principal rather than as agent; the movement toward an integrated financial services market — that is, the integration of the four pillars; the ongoing process of financial deregulation in Canada; the Montreal challenge, by which is meant concerns not only about the prospects of international banking centers but more generally about the ability of a small, open jurisdiction like Ontario to exercise control over a much larger territory in the context of mobile money, mobile ideas, and even mobile firms; and, finally, reciprocity.

Designing policy alternatives that achieve the objectives while recognizing the challenges is difficult because Ontario's existing regulatory structure is obsolete. The incentives embedded in the current regulatory framework were designed initially for a world in which markets were primarily regional in nature and in which the retail investor was more important than the institutional investor. Not surprisingly, these incentives created a structure for the Canadian industry that was conducive to the emergence of integrated securities firms such as Dominion Securities Pitfield, McLeod Young Weir, and Wood Gundy.

The current realities are, however, that markets are becoming increasingly international and that institutional investors are becoming increasingly dominant. But the regulatory provisions ensure that registered firms are at a disadvantage when it comes to these new realities. The relatively undercapitalized, integrated firm spreading its capital across the exempt, underwriting, and distribution functions is becoming progressively easier prey for well-capitalized, nonregistered, domestic and foreign institutions that focus on particular market niches such as trading in selected exempt securities and underwriting Canadian issues abroad. One result has been that the Canadian industry has lost the bulk of the underwriting and placing of government and corporate bonds in the Euromarket. The domestic exempt market appears to be next in line for takeover. If this market is eroded, the integrated firms will have lost the very domestic base from which their existing strength derives. Without this base, they have little hope of "catching the wave" of the growing internationalization of securities markets. Instead, they face being relegated gradually to the role of regional players in a market where growth is taking place in international activities, while Toronto will run the risk of becoming primarily a regional, rather than an international, financial center.

The Dey and Dupré Reports: A Comparison

The two "official" models for reform presented to the Ontario government were the OSC proposal (the Dey report) and the Ontario Task Force recommendations (the Dupré report). It is instructive to compare their implications.

The philosophical foundations of the two reports are almost at opposite ends of the spectrum. While the Dupré report would allow agents to acquire 20 percent slices of securities firms, the report's thrust recommended little change from the status quo. The proposed increase in ownership limits, for example, is probably insufficient to attract many investors. Moreover, since the registered market would remain intact, it is quite possible that many securities firms would simply continue with business as usual — that is, there would be little incentive for Canadian securities firms to take advantage of this extra freedom.

The thrust of the Dey report was just the opposite: it recommended forcing Canadian firms to adjust by exposing them to increased competition. This objective is to be accomplished by allowing foreign firms to enter as foreign dealer registrants and to pursue the entire range of business open to domestic firms. It is true that these foreign dealer registrants would be operating

institutions at the expense of domestic institutions, particularly when this represents a curtailing of the *existing* powers of these Canadian institutions?

An Alternative Future for the Canadian Securities Industry

The concerns expressed in the previous section, as well as other reservations, have led us to develop an alternative securities industry policy for Ontario.[11] Ideally, we would like to be able to outline the preferred future for the industry by building on a generally agreed set of underlying principles, particularly those relating to the four-pillar concept. But it is clear from the experience of other countries that no such principles exist; in fact, one can observe all sorts of pillar combinations. It also would be immensely helpful if one could assert, as a base position, that securities firms ought to be controlled by industry insiders. It is indeed the case that some of the most successful securities firms are organized as partnerships, but at least as many appear to be wholly owned subsidiaries.

Thus, what follows is not intended as an analysis based on generally accepted first principles. Rather, it is based more on "positive" than "normative" analysis. In other words, given the various trends elaborated above, our analysis focuses on those regulations and policies that would ensure that Ontario maintains and expands its position within the Canadian and global securities environment. In this sense, we are not setting forth a "preferred alternative" for the future of the securities industry. Rather, we are proposing a "benchmark" approach, derogations from which ought to be justified by overriding public policy concerns.

With these important caveats in mind, we now begin to establish this benchmark approach.

Situating the Issues in the Appropriate Context

The Ontario government is having a difficult time coming to grips with the policy environment for the securities industry — that is, Ontario is finding it difficult to reconcile its underlying objectives with the challenges to the industry. One reason for this difficulty is that three key issues have

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[11] As the reader is no doubt already aware, Ontario's proposals follow closely those of the Dey report. Hence, implicitly at least, we already have begun the analysis of these proposals. In terms of the structure of this study, however, we have opted to present our preferred policy alternative first, leaving to the final substantive section of the study a full evaluation of Ontario's position, including some possible amendments to its policy stance.

been approached from a perspective that confuses the policy options and reduces the likelihood of an appropriate solution. We highlight these issues below and then compare the perspective they suggest with the rapidly changing world environment.

Canadian Ownership

The first issue is the ownership of the Canadian securities industry. Until recently, the Ontario securities industry has tended to argue that ownership should remain substantially or overwhelmingly Canadian. We have no quarrel at all with this objective. Indeed, the entire thrust of the benchmark proposal that follows is geared to achieving Canadian control. What this objective has tended to mean in practice, however, is that the existing range of operations of the 100 or so securities firms should remain Canadian controlled. The result of adhering to this policy has been that, over the years, Canadians have lost control to merchant bankers and foreign firms — or have failed to acquire control — of a very substantial portion of securities-related business in Canada.

A more effective approach to Canadian ownerhip would be to design a policy framework that allows Canadian firms to *regain* control of the Canadian securities-related business, particularly of that portion now carried out by foreign firms. To worry about Canadian control in the context of a very restricted set of securities-related activities, such as registered market activities, is to lose sight of the forest for a few trees.

Ontario and the Four Pillars

The second issue has been Ontario's persistent adherence to the notion that underlying its four-pillar concept are both regulatory separation and ownership separation. The former is generally accepted. In terms of the issue at hand, it implies that institutions involved in the securities pillar should be subject to separate regulation, part of which involves OSC supervision and comparable supervision by the securities commissions of other provinces. The latter is more troublesome.

It appears that the only other jurisdiction that espouses the traditional Ontario approach toward ownership separation is Japan. The Japanese comparison, however, is not very constructive, since Japanese securities firms already are dominant global players. And in any event, the process of allowing cross-pillar integration is now under way in Japan. Certainly the United States does not embrace this approach, with Prudential, American Express, and Sears Roebuck able to own securities firms. Quebec now allows owner-

ship integration across the pillars. So will Ottawa, if the Green Paper is any indication, since the proposed financial holding company concept is designed explicitly to accommodate cross-pillar ownership. Under this rubric, Ottawa would even allow FHCs to acquire securities firms. Orion Royal Bank recently bought a British broker and it also owns a securities firm in Australia. In most of continental Europe there is really only one pillar. In the face of these trends, it appears that Ontario's policy is offside; reconsideration would seem to be in order if the rest of the world is not to pass the province by.

As important, however, is the fact that in today's increasingly innovative environment, it is becoming virtually impossible to provide a line of demarcation between various types of financial instruments. There is a growing literature on the "securitization of bank loans" — loans or slices of loans that are traded among institutions. These corporate loans are becoming indistinguishable from corporate bonds. Will Ontario ban these loans because they run counter to the separation of pillars? Can it do so, constitutionally, if the *Bank Act* permits such practices?

The severity of this problem has arisen because Ontario's regulatory environment has tended to protect the securities industry since the early 1970s. One unintended consequence of such protection is that security firms have adapted slowly to the changing world environment.

Industry-Insider Control

The third issue is control by insiders. It has been argued that unless a securities firm is "industry-insider controlled", it will lose "professionalism". The implication of this is that narrowly held securities firms such as Prudential-Bache, Dean Witter Reynolds, and Orion Royal Bank somehow lack professionalism.

The fact is that control by industry insiders has created an entry barrier to the Canadian securities industry for new and small firms. No viable means exist whereby the new and small can amass the capital needed to challenge the old and established. The issue can be phrased differently: in the current securities environment, which is progressively dominated by worldwide operators and financial conglomerates, Ontario regulates the industry in a way that hinders securities firms to be other than partnerships. Yet if such partnerships are so advantageous as an organizational form for the securities industry, why do they not dominate global securities activity? The reality is that we probably will see more large players in the Canadian securities

industry. Ontario's current policy may well be guaranteeing that these large players will be foreigners.

Our intention is not to suggest that Canadian securities firms should be forced to transfer control from industry insiders to outside owners. Rather it is that such firms should not be precluded from bringing in a significant outside owner.

Ontario and the World Environment

Confusion on the three key ownership issues has contributed to a situation where, in the current world environment, Canadian securities firms are becoming regional brokers and the Toronto-based location of the industry is increasingly open to challenge.

A more appropriate perspective on these issues is required by the Ontario government. In addition, it will have to recognize that its role as the regulator for the Canadian securities industry has altered correspondingly. When markets were essentially national or regional in nature, Ontario could indeed have its way with the system's structure. The threat of denying access to the TSE to out-of-province securities firms with a different ownership structure was, and to a large degree still is, sufficient to force those firms to toe the Ontario line. This is clearly about to change. It is true that, as yet, there has been no attempt to take over an established securities firm, despite ownership deregulation in Quebec. It may well be that established firms will not allow outsider ownership to go beyond 10 percent for fear of losing their current TSE-related business. This simply means that financial conglomerates or banks — if federal legislation permits — may find it more attractive to establish new firms in Quebec or in other provinces that adopt more open legislation. In this context, the introduction of IBCs or IFCs could be particularly problematic for Ontario, particularly if the federal government allows the pending Quebec legislation to define the sorts of activities that can be conducted in those designated centers.

The point, however, is a general one. In a closed-economy, national-capital-markets framework, Ontario had sufficient power to force the entire Canadian system to abide by its provisions. In an open-economy, international-capital-markets framework, it has no such power or influence, and the system will simply bypass Ontario if the province remains inward-looking. This is the fundamental message that derives from the increasing internationalization of markets. It holds with more force in the financial area than in other sectors because money and ideas are inherently fungible and because financial institutions are inherently mobile. Unless Ontario recog-

nizes this fundamental change in the securities industry, its policies are likely to be detrimental to the longer-term vitality of Toronto and to the Canadian securities industry. This is the message we received forcefully from virtually every nonindustry person we interviewed and, interestingly enough, from some industry people as well.

OSC chairman Stanley Beck has made many of these points. Drawing on recent work by the World Bank, Beck has articulated the steps in the ineluctable process toward the globalization of financial markets:

> Financial instruments will become more uniform worldwide. Similar types of financial instruments, combined with [currency] swaps, will make the concept of borrowing in a specific currency increasingly meaningless.
>
> The borders between various types of financial institutions will gradually disappear. The national monopoly held by domestic banks, insurance companies and securities dealers will gradually be eroded by international competition. At the same time, the most efficient domestic financial institutions will become global players and increasingly participate in international transactions with a strong presence in other financial centres. The less efficient financial institutions will gradually lose market share, be merged or disappear.
>
> As worldwide trading, execution, and settlement overcome various technical hurdles, the floors of national securities exchanges will gradually be replaced by computer terminals in a series of trading rooms housed in the major investment banks in each financial centre. Markets will be linked by computers and telephones on a worldwide basis. Information standards, trading rules and settlement procedures will be fully harmonized, effectively linking markets.
>
> As a result, the meaning of 'Euro' and 'foreign' versus 'domestic' markets will gradually disappear.[12]

The implication of these predictions is that a strong international presence is increasingly the key to being successful domestically in the securities industry. The Canadian institutions that currently have this global presence are the schedule A banks, not the securities firms. It also appears that Canadian financial conglomerates are making substantial headway in penetrating international markets. Unless these institutions are allowed into the

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[12] Stanley M. Beck, "The Securities Industry — Prospects and Problems" (Remarks to the Conference Board of Canada 1986 Financial Conference, Toronto, May 1, 1986), pp. 12–14.

securities core, it seems all too evident that foreign securities firms will come to dominate the Canadian securities business. And, as noted above, even though the Dey report's proposals would enhance competition in the securities industry, the report explicitly favored foreign securities firms over Canadian financial institutions.

To be sure, Canadian securities firms can merge in order to enhance their capital base and stave off foreign competition. The attempted merger between Gordon Capital Corporation and Wood Gundy in mid-1986 illustrates this point well. In some sense, this would have been an ideal merger: an aggressive firm like Gordon Capital, with its focus on institutional and investment banking activity, could make an ideal partner for an integrated firm with considerable international presence like Wood Gundy. (While the merger may well have been "ideal", it also would have been a peculiar one in the sense that these two firms were at the opposite ends of the spectrum in terms of the 1984 OSC hearings, with Gordon Capital pushing for an easing of ownership restrictions and Wood Gundy's Ted Medland chairing the JSIC report, which argued for increased protection.) Other possibilities for mergers of domestic firms that will generate the needed expertise on the international front are few.

It seems fair to conclude, therefore, that if the securities industry is to remain substantially Canadian, both the Ontario and federal governments will have to broaden their policy horizons.

Toward a World-Class Canadian Securities Industry

With these perspectives in mind, we have developed a model approach for the future regulation of the Canadian securities industry. The approach may well have some serious flaws, but the burden of proof and proposals for further alternatives should lie with those groups who wish to cast Ontario policy in a more restrictive mode. The model has the following characteristics:

- Canadian individuals and financial institutions should be allowed, in a staged fashion, to own 100 percent of a securities firm. The staging should not be too drawn out — for example, 25 percent in year one, 50 percent in year two, and 100 percent in year three. This regulatory change should be announced immediately.
- Foreign securities firms should have the option of buying into an existing Canadian securities firm — subject to an overall limit of, say, 35 percent — or of applying to come into Canada as registered foreign dealers on the day that the next *Bank Act* revision becomes law (the reason for this will

be revealed shortly). This foreign dealer registration would be subject to some initial capital requirements, but the announcement should signify that these limitations will be relaxed over time. Again, this regulatory change should be announced immediately.

- The role of the chartered banks and other federally chartered financial institutions in all of this is somewhat beyond Ontario's jurisdiction. In general, however, there are two options available. One is to include them under the first provision — that is, they could be allowed to own 100 percent of a securities firm. Constitutionally, Ontario probably could not exclude the chartered banks if it opened the door for, say, provincially chartered trust companies. The second option is to allow the chartered banks' merchant banking subsidiaries to enter as "foreign" registered dealers. That the banks ought to be allowed into the system in some way or another seems obvious. There is no rationale at all for allowing Deutsche Bank or even Salomon Brothers to enter Canada while at the same time refusing entry to the chartered banks. The capital of Salomon Brothers is roughly equal to that of The Royal Bank of Canada. Hence, if the banks were excluded, foreign giants would gain an edge over domestic giants. The problem is that ultimate control over the banks rests with the federal government and with revisions to the *Bank Act*. If the act allowed the chartered banks to acquire securities firms — which the Green Paper and the Blenkarn and Murray reports all recommend — then Ontario may as well open up the system to the banks, because the banks' alternative would be to buy Quebec-based securities firms. Instead, however, Ontario might lobby the federal government to permit the banks' merchant banking subsidiaries to register as foreign dealer registrants. In any event, it seems appropriate that the banks and other federally chartered financial institutions not be put at a disadvantage relative to foreign firms; hence, the rationale for delaying foreign dealer registration until the day that the next *Bank Act* revisions become law.
- All foreign dealer registrants should be encouraged, or perhaps required, to have seats on the TSE. For its part, the TSE should be instructed to ensure that these extra seats not be at the expense of existing Canadian registered dealers.
- Finally, securities firms should be allowed the same freedoms to diversify as the rest of the financial sector; securities firms should be able to branch into other pillars by means of subsidiaries or holding companies.[13]

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[13] While the Murray report allowed for cross-pillar ownership, it too had ownership provisions for financial institutions that range beyond their core activities. Specifically,

Such a model would be expected to have a number of important implications:

- Canadian securities firms finally would have complete freedom to attract additional capital and the ability to develop a significant international presence.
- Those firms that wished to remain controlled by industry insiders would still have substantially more freedom than would be the case under the Dey report's proposals.
- Canadian firms probably would have a head start on the foreign competition in terms of registered activity, which would be modeled along the lines of proposals contained in the Dey report. The reason for this delay is not so much because of a desire to favor Canadian over foreign firms but because it seems appropriate not to give foreign firms an advantage over the chartered banks. Nonetheless, the head start would allow Canadian firms to gear up for the challenge of foreign competition.
- Allowing foreign firms to enter would encourage Canadian firms to rationalize and to take advantage of a freer system.
- Canadian securities firms would be able to capitalize to meet the foreign competition; they would also be able to develop a sufficient international presence to "repatriate" at least some — and possibly a considerable amount — of the securities business that has been lost to foreigners over the years. Thus, the goal of Canadian control of the industry's activities finally could be achievable.
- Toronto's attractiveness as a financial center would be enhanced. The Ontario government should be encouraged to require that lead underwriters of its issues should be registered and domiciled in Canada. Indeed, Ontario could attempt to persuade the federal government also to give preference to underwriters registered as dealers in Canada. This should not impose much, if any, cost in terms of financing — Salomon Brothers, for example, probably would be a foreign registrant.

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where one financial institution has a controlling interest in another financial institution operating in a different pillar, either the institution itself or the subsidiary would have to have 35 percent of its shares traded publicly. For financial conglomerates, if the financial holding company does not have 35 percent of its shares traded publicly, then all of its subsidiaries would have to be publicly traded to the extent of 35 percent. Since schedule A banks are widely held, they could, under these provisions, wholly own a securities firm. If a securities firm were to acquire a trust company, for example, the 35 percent provision would apply.

• Much or most of the securities-related activity that is currently booked offshore would be expected to return to Canada and probably to Toronto. This implies that ancilliary services such as lawyers and accountants also might be booked in Canada.
• Users of securities industry services also would be major beneficiaries.
• Domestically oriented institutions — such as caisses populaires and some trust companies — could team up with dealers that currently focus on the retail market. This would generate a distribution system that clearly would give Canadians far greater access to the industry than so far has been the case.
• Concerns relating to self-dealing and other issues would be eased if measures such as enhanced corporate governance — along the lines of proposals contained in the Blenkarn or Murray reports — were implemented. Note that as far as the chartered banks are concerned, the fact that they are widely held serves to minimize concerns relating to self-dealing.

Our model for the Canadian securities industry has important positive implications for structuring a Canadian industry that will be better adapted to the international environment. Lesser changes surely will mean different regulatory environments in Quebec and Ontario. Recognition on the part of the federal government that Ontario is maintaining a restrictive regulatory posture may result in the adoption of a very broad definition of what is allowable in IBCs. Not surprisingly, therefore, Ontario has taken some critically important steps in this direction. To this we now turn.

The Ontario Initiatives

Ontario now has signaled its intention to introduce legislation along the lines of the Dey report's proposals. To repeat, the thrust of the reforms will be as follows:

• Any domestic financial institution or nonfinancial firm and any nonresident will be able to own up to 30 percent of a securities firm.
• A nonresident will be able to apply to register as a foreign securities dealer. The total capital of such foreign dealers will be limited to 30 percent of total industry capital, and any one foreign dealer will be limited to 1.5 percent of total industry capital. Nonresident entrants will be required to meet defined standards of performance prior to being registered;
• All participants in the exempt market will be registered and subject to the provisions of registration.

As the Ontario announcement notes, "the adoption of these principles relating to the ownership of, and entry into, the securities industry leaves many important matters of implementation and of developing ongoing rules to be settled."[14] It falls to the OSC, in consultation with the industry, to draft the relevant regulations, the objective being a draft bill in the fall and a target date for implementation of January 1, 1987.

These proposals go beyond those of the Dey report in some respects. First of all, not only do they stress that the entry of Canadian financial institutions into the securities sector is essential to the growth of Toronto as a world financial center, but they also call on the federal government to follow Ontario's lead in passing the requisite enabling amendments to the relevant federal statutes, "including the *Bank Act*."[15] While we later voice some concerns about the role that the announcement allots to banks, the central message here appears to be that Ontario is finally well on the way toward abandoning its long-held views on ownership separation across the pillars. As evidence of this, the announcement states that "while we have set a 30 percent ownership limit for non-resident investors, we are prepared to discuss allowing Canadian financial institutions to obtain an even higher ownership level."[16]

Whereas the Dey report would limit foreign dealer registrants to Canadian subsidiaries of foreign securities firms, the Ontario proposals indicate that "nonresidents" would be able to apply for such status. It may well be that this wording is intentional in order to accommodate the offshore merchant banking subsidiaries of the chartered banks. Presumably, this item will be clarified in the regulations.

Generally, however, the level of detail in the proposals as they now exist is not sufficient to provide a full picture of what the eventual policy will be. The Dey report, for example, proposed that nonresidents or financial institutions be allowed to own up to 30 percent of the share of a securities firm, but that once the 10 percent ownership level is reached, the securities firm must have one signficant industry investor — presumably an industry-insider holding company — owning in excess of 50 percent of the participating and voting shares. These and similar details are absent from Ontario's proposals but obviously will be incorporated in the draft bill.

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[14] Ontario, Ministry of Financial Institutions, *News Release*, Toronto, June 11, 1986, p. 4.
[15] Ibid., p. 5.
[16] Ibid., p. 6.

Even without the advantage of having the full-blown proposals available, it seems clear that some of the key provisions are bound to prove difficult to implement.

The Role of Banks

Now that Ontario has opened the door for banks to become substantial shareholders in securities firms, it will be very difficult to prevent banks and other Canadian financial institutions from wholly owning existing securities firms or from establishing new ones. To see this, consider the options available to the federal government. Unless Ontario can obtain full agreement of all the provinces for its position, it is unlikely that the federal government will enact legislation of the sort that would incorporate a specific ownership limit such as 30 percent. More likely, it will amend the *Bank Act* to allow banks to own securities firms subject to the regulations of the various provinces. Under such a provision, Ontario probably would be forced to open up the securities industry fully, presumably to forestall the chartered banks buying or establishing Quebec-based securities firms. An alternative approach for Ontario would be to allow the banks' offshore merchant banking subsidiaries to come in as foreign dealer registrants. As noted below, however, this is unlikely to be acceptable to financial intermediaries in the other pillars.

One option that would address this issue would be for the federal government to prevent the banks from entering the securities core. But Ontario already has requested that the banks' range of ownership powers be extended. Moreover, both the Senate and House of Commons reports on financial regulation argue for extended ownership powers. And both Quebec and British Columbia expect the federal government to act on the issue of IBCs, which, presumably, would allow the banks to establish domestic firms for their international securities business.

In short, it appears difficult to conceive of a situation where opening up the securities industry to, say, 30 percent ownership by banks will be the end of the story.

It may be easier to argue that nonfinancial corporations be limited to a 30 percent ownership stake in a securities firm. But if there is an FHC between the nonfinancial corporation and the securities firm, then it may be difficult to justify treating the FHC differently from other financial institutions. One might insist that the FHC have some publicly traded securities; one also might want to ensure that appropriate provisions are in place to control self-dealing and abuses of conflicts of interest (along the lines, say,

of those contained in the Murray report). But these are provisions that ought to apply across the board to all financial institutions engaging in ownership integration across the pillars.

The Exempt Market

A further problem relates to Ontario's proposals to extend the scope of the exempt market. Under the Dey report's recommendations — the model followed by Ontario — "the exemptions for specified financial institutions, exempt purchasers, and $97,000 private placements would not be available to non-registrants who rely on these exemptions to carry on, in effect, a private underwriting or full-service brokerage business."[17] The Dey report would require that institutions register to carry on these activities and that registration would involve abiding by the new ownership requirements.

Since financial institutions cannot establish securities firms, they would be relegated to carrying out these activities through securities firms in which they hold, at most, a 30 percent voting interest. It is far from obvious that Ontario could make such a provision stick, for two reasons. First, it is always difficult to roll back the existing powers of financial institutions, particularly where these institutions are chartered in other jurisdictions that would continue to allow such activities. Second, such legislation almost surely would lead to a Supreme Court challenge, which, given the increasing internationalization of capital markets, may well result in the Court assigning priority to the federal trade and commerce power over the property and civil rights clause for the regulation of capital markets.[18] But even if it does not go this far, the ongoing process of securitization of financial instruments and the general blurring of the distinction between various types of financial instruments makes it increasingly difficult to specify a meaningful line of demarcation between the activities of various financial institutions.

Once again, the only viable solution may be to open up the securities core to other financial institutions. As a halfway house, perhaps, one could establish a separate category — a "financial institution registrant" — which would specify a maximum capital base for securities firms that are subsidiaries of financial institutions.

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[17] Ontario Securities Commission, *A Regulatory Framework*, p. 36.
[18] Courchene, "Regulating the Canadian Financial System."

Schedule B Banks

A final area of concern relates to the schedule B banks, many of which now engage in exempt-market activities. The Dey report would cut them off completely. They would not qualify as foreign dealer registrants and, not being "nonresidents", they would not be able to buy into existing Canadian securities firms. Presumably, they would have the choice of deciding whether to keep their schedule B charters or to become foreign dealer registrants. But the limit of 20 foreign dealer registrants would preclude this option for all but a few, since easily more than this number of foreign firms would desire access to the Canadian market in this category.

While Ontario's proposals represent a potential and refreshing opening up of the Canadian securities industry, it is far from clear that the Ontario model can be viewed as anything more than an interim step toward much more comprehensive financial deregulation. We believe, therefore, that the recommendations for reform presented in the previous section are a superior model for financial deregulation. And the most appealing feature of this model is that it provides maximum freedom immediately for Canadian firms to capitalize and expand in order to attempt to regain the substantial segment of the Canadian securities market that has been lost to foreigners over the last few decades.

Conclusion

Ontario has taken a progressive, if incomplete, step in the direction of enhancing competition in the Canadian securities industry. A risk exists, however, that the process of writing the regulations pursuant to the proposals will become little more than an exercise in rebuilding some of the protective walls around the industry. While Ontario should ensure that the process of opening up the securities industry does not lead to the domestic industry being overwhelmed by foreign competition, this is quite different from its re-establishing, through regulations, the comfortable protective niche in which Canadian firms have long operated.

The trend, worldwide, is toward global capital markets. In the face of such a reality, we conclude that the only viable approach to reform is to allow Canadian firms every advantage to compete both domestically and internationally. We trust that in the policy debates and subsequent drafting of regulations, the Ontario government and the OSC will follow the approach the OSC itself adopted in one of its earlier reports — namely, that "the presumption is that any action is permissible unless it can be demonstrated

to be contrary to the public interest."[19] In other words, the burden of proof should be placed where it belongs: on those who argue for the maintenance of the status quo, rather than on those who want to innovate, to capitalize, and to become global players. Given the rapidly evolving nature of the international securities industry, we are confident that such an approach will lead Ontario to open up the Canadian securities industry along the lines we recommend.

We conclude by recognizing explicitly that a degree of schizophrenia pervades this analysis. The study has been directed toward Ontario and toward the goals — for example, to ensure that Toronto remains the capital of the Canadian financial sector — that presumably underlie the Ontario government's decisionmaking process. In the broader context, however, our pre-eminent concern is that the Canadian securities industry serve Canadians well. In this broader context, the reality is that Ontario's regulatory changes may not have much impact on the evolution of the industry. The process of globalization of capital markets is irreversible. The forces for domestic change already are well established and are gaining momentum. In the face of highly mobile capital, ideas, and institutions, Ontario does not have a monopoly on how the industry will evolve. Competitive forces — in markets and in jurisdictions — will ensure that Canadian borrowers and investors get a securities industry that serves them well. In the final analysis, therefore, it may be that Ontario can determine merely how much securities industry activity eventually will be domiciled in Toronto and how much will remain under its jurisdiction. The real choice for Ontario is whether to lead or be led.

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[19] Ontario Securities Commission, *Report on the Implications for Canadian Capital Markets of the Provision by Financial Institutions of Access to Discount Brokerage Services* (Toronto: Dataline, 1983), p. 16.

Policy Analysis Committee

The C.D. Howe Institute Policy Analysis Committee (HIPAC) was formed in 1980 from the Canadian Economic Policy Committee, established in 1961. This change was brought about to help streamline the Institute's activities and to improve the process of accountability of staff to the Institute's members.

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Full meetings of HIPAC's membership are held twice each year. The purposes of these meetings are to hear expert speakers on current policies, to engage in frank discussion of topics raised by members, and to identify a research program that the Institute can carry out effectively to improve public understanding of important policy issues. The professional completion of this program is then supervised by the Institute, which coordinates with the HIPAC Executive Committee.

The Chairman of HIPAC is H.A. Hampson (President and Chief Executive Officer, Canada Development Corporation).

Recent publications prepared in conjunction with HIPAC include:

- *Monetary Policy in Transition: A Study of Bank of Canada Policy, 1982–85*, Policy Study no. 1, by Peter Howitt (October 1986).
- *Staying on Course*, C.D. Howe Institute Commentary no. 12, by Peter F. Bartha (October 1986).
- *Closing a Trade Deal: The Provinces' Role*, C.D. Howe Institute Commentary no. 11, by Murray G. Smith (August 1986).
- *New Stresses on Confederation: Diverging Regional Economies*, Observation no. 28, by Edward A. Carmichael (June 1986).
- *Reorienting the Canadian Economy: Policy Review and Outlook, 1986*, by Edward A. Carmichael (December 1985).
- *Taking the Initiative: Canada's Trade Options in a Turbulent World*, Observation no. 27, by Richard G. Lipsey and Murray G. Smith (May 1985).